



Independent Bank

230 West Main
Ionia, MI 48846

October 11, 2012

Via E-Mail: regs.comments@federalreserve.gov

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

RE: **RIN# 3064-AD95**

Comments of Independent Bank on the Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Ms. Johnson:

This letter is submitted on behalf of Independent Bank. In this letter, Independent Bank provides its comments on the Notice of Proposed Rulemaking (NPR) regarding regulatory capital rules.

Unrealized Gains or Losses on Available -For-Sale Securities

The NPR proposes that unrealized gains or losses on Available-For-Sale (AFS) securities would flow through regulatory capital. This proposal will increase the volatility of regulatory capital measures and is fraught with unintended consequences, including potentially causing more banks to hold securities as held-to-maturity and thus having less flexibility in managing liquidity and interest rate risk.

This proposal ignores the fact that many of the assets and liabilities in the banking industry are illiquid. Adjusting regulatory capital for market value changes in only one portion of the balance sheet does not provide an accurate picture of a bank's financial health or risk profile.

We would point to a common transaction in our balance sheet to provide an example of the inconsistency of applying mark-to-market accounting for only part of the balance sheet. Consider the case of new checking accounts opened by the Bank with the proceeds

invested in securities AFS. Under the proposal, unrealized gains and losses on the investment would be realized in regulatory capital but changes in the value of the deposit account would be ignored. Specifically, in a rising rate environment, regulatory capital will decline. However, the checking accounts will be more valuable for the Bank; and under the proposed framework this value would not be recognized.

Our Bank currently designates all securities as available for sale in order to maximize the liquidity potential of the investment portfolio and to provide the greatest degree of flexibility to adjust portfolio holdings in order to achieve asset / liability management objectives.

We advocate that this proposed rule be revised so that unrealized gains and losses on AFS securities do not impact regulatory capital. Our position is based on the following considerations:

- The proposal would result in declining regulatory capital levels during periods of rising interest rates, widening credit spreads or illiquidity. These declines may be based on temporary factors and may not be indicative of a bank's risk profile.
- Our Bank uses the investment portfolio as an avenue to adjust its interest rate risk profile. This strategy generally requires purchased securities to be designated as AFS so the overall interest rate risk profile may be adjusted as the balance sheet and / or the preferences of our banking customers change. Additionally, this strategy may entail the acquisition of longer duration securities which receive unfavorable treatment under the NPR.
- Our Bank's investment portfolio is a key component of our liquidity management activities. This strategy requires securities to be designated as AFS.
- The necessity for including market based adjustments in regulatory capital is obviated by the strictures of U.S. GAAP. Accounting standards require a thorough review of the investment portfolio for other than temporary impairment (OTTI). Credit related OTTI is already recognized in regulatory capital through charges against current period earnings.
- The NPR results in disparate regulatory capital treatment for the exact same security based on accounting designation. An institution that designates a security as AFS will be subject to volatility in regulatory capital levels, while an institution that designates the same security as Held-To-Maturity (HTM) will avoid swings in regulatory capital due to temporary price changes. The risk posed by the investment will be the same, but the regulatory capital required will differ as rates and / or spreads change. Additionally, the institution that designates the security as HTM may have a higher liquidity or market sensitivity risk profile.
- This proposal is inconsistent with the proposed treatment of unrealized gains and losses on cash flow hedges.
- This proposal may increase funding costs for sectors of the economy dependent upon long term financing. Examples include housing and municipal finance which generally issue longer duration debt instruments. This proposal may decrease demand for longer term debt issuance from the banking industry.

If the banking regulatory agencies are determined to require unrealized gains and losses to flow through regulatory capital, we strongly suggest that unrealized gains and losses that predominantly result from changes in interest rate risk should be carved out. In other words, the banking regulatory agencies should consider excluding unrealized gains and losses for securities that do not have credit risk. This approach would exclude from regulatory capital unrealized gains and losses resulting from low-risk securities, such as U.S. government and agency debt obligations, U.S. GSE debt obligations as well as general obligation debt issued by state and local municipalities.

Severe Risk Weights for Residential Mortgages

The NPR creates a dramatic increase in regulatory capital requirements for residential mortgage loans. Furthermore, the NPR greatly increases the complexity and recordkeeping requirements to determine regulatory risk-weights.

Independent Bank is a community bank that has historically dedicated considerable resources to residential mortgage lending. At June 30, 2012, residential mortgages accounted for almost 50% of our loan portfolio so this is an important topic for our institution.

The credit performance of residential mortgages during the past five years has been much worse than what most industry professionals thought possible. So the regulatory reaction to increase capital requirements and underwriting guidelines is understandable.

Nevertheless, we believe that the measures proposed in the NPR go too far and will suppress new balance sheet lending activity by banks, increase the cost to consumers of new loans and increase the recordkeeping requirements for filing regulatory reports. We believe that these adverse consequences will have a significant negative impact on the U.S. housing market and the economy as a whole.

We would encourage the banking regulatory agencies to adopt a simpler methodology with lower risk-weights. The risk-weights for residential mortgages should not be higher than other types of lending. Our position is based on the following considerations:

- The large increase in risk-weights for residential mortgages appears to be reactionary. The most recent financial crisis was created in part by excessive leverage in the residential housing sector. The source of the next credit crisis is yet unknown. It may well emanate from student loans, auto loans or C&I lending. It does not make sense to capitalize a residential mortgage loan at twice the level of an auto or C&I loan with the same loan to collateral value and underwriting guidelines.
- The NPR prescribes an increase in the quality of capital (common equity) and the maintenance of additional capital, including a capital conservation buffer. These proposals are sound and serve to reduce risk in the system.
- Current loan loss reserve methodologies already consider the risk profile of an institution's loans, furthering the goals of this proposal.

- Setting risk-weights in light of some of the worst credit performance in several generations will drastically alter the business model for residential mortgage lending.
- The higher regulatory capital requirements in this NPR will result in higher lending rates for borrowers.
- Requiring up to 21% capital for some transactions will restrict credit availability as the rate likely can not be increased sufficiently to maintain profitability targets while providing customers with a reasonable interest rate. These transactions will effectively move from the regulated banking industry, if they can be financed at all.
- The NPR does not make any allowances for existing mortgage loans.
- Accumulating the required data to properly designate existing loans will be difficult and time consuming. Our Bank currently has over 8,000 residential mortgages that would need to be reviewed and classified.
- The NPR considers a myriad of underwriting guidelines. **However, it does not consider the payment history of a loan.** Our Bank has a number of loans that would likely be designated as category 2 that have never missed a payment in four to five years. A loan that has performed well throughout the most recent crisis should not arbitrarily be assigned a higher risk-weight.
- Retroactively increasing the capital allocation for existing mortgages will likely result in a significant rise in regulatory capital requirements.

Severe Capital Treatment for Mortgage Servicing Rights

The NPR would limit our Bank's ability to service mortgage loans for our customers by deducting any mortgage servicing rights in excess of 10% of common equity from capital. Furthermore, the punitive risk-weighting (250% in 2018) will create a strong incentive for this business to leave the banking industry.

Independent Bank services most of the mortgage loans that we originate. Our servicing activities are a significant part of our business model as loans serviced for others currently equals \$1.8 billion, which actually exceeds the volume of loans retained on our balance sheet. Our customers enjoy having a local bank service their mortgage. Furthermore, this activity fits well with other retail banking strategies. We have found that servicing a customer's mortgage loan provides avenues for providing checking accounts and other banking relationships. We also believe that community banks have generally done a better job of servicing mortgage loans during the recent housing crisis when compared to the largest mortgage loan servicers. We feel that this proposed regulatory capital treatment for mortgage servicing rights will lead to yet a greater concentration of mortgage loan servicing with just a few very large institutions that are outside the scope of this NPR.

We ask that the banking regulatory agencies significantly moderate the capital allocation for mortgage servicing rights. While mortgage servicing has a unique risk profile it is a key customer relationship for community banks. Our position is based on the following considerations:

- These assets already receive a high degree of scrutiny and regular valuations. Each quarter our mortgage servicing rights are valued by an independent third-party and our carrying amount is adjusted to fair value through charges to earnings.
- Regulatory treatment already values these assets at fair value less a 10% haircut.
- The proposed terminal capital ratio for these assets at over 26% is extremely high. The ultimate cash flows of this asset are subject to a fair amount of variability. Therefore, when determining fair value, the cash flows are discounted back at a fairly high rate (11% on our most recent review). The existing regulatory framework of regular, independent valuations based on high discount rates and a 10% haircut already generates conservative values for these assets.

If the banking regulatory agencies are determined to implement concentration limits for this asset, we would suggest a higher threshold of 25% of capital, consistent with existing regulatory guidelines regarding concentrations. Additionally, we would suggest that a low concentration limit would eliminate the need for the arbitrary 10% regulatory haircut for these assets.

Finally, many community banks have limited access to the capital markets and therefore, encounter difficulty in raising additional capital. In general, the NPR, as proposed, may limit the growth of community banks unless they significantly increase capital. Various provisions in Dodd-Frank differentiated community banks based on asset size (for example, certain provisions did not apply to banks with less than \$10 billion in total assets). We believe the NPR should make a similar distinction with a much higher threshold than the current level of \$500 million in total assets.

Independent Bank values this opportunity to comment on this important topic. If you have any questions on these comments please contact me.

Sincerely,



Robert N. Shuster
Executive Vice President and Chief Financial Officer